

Public Service Commission of Wisconsin
Supplemental Direct Testimony of Lois J. Hubert
Gas and Energy Division

Milwaukee Water Works
Docket 3720-WR-107

June 21, 2010

1 Q. Please state your name, business address and occupation.

2 A. My name is Lois J. Hubert, and my business address is the Public Service Commission of
3 Wisconsin (Commission), 610 N. Whitney Way, P.O. Box 7854, Madison, Wisconsin
4 53707-7854. I am employed by the Commission as the chief Public Utility Financial
5 Analyst in the Gas and Energy Division.

6 Q. Please describe your qualifications and work experience.

7 A. I graduated in 1974 from Central Michigan University with a Bachelor of Science degree
8 in Business Administration. My major was management and my minor was mathematics.
9 I also earned a Master of Business Administration (1984) from the University of
10 Wisconsin – Milwaukee. I have worked in the utility industry since 1970. Prior to my
11 employment with the Commission, I was employed for 15 years at Wisconsin Electric
12 Power Company (WEPCO). While at WEPCO, I performed various functions in the
13 property accounting, the corporate securities, and the rate/regulatory areas.

14 Q. How long have you been employed by the Commission?

15 A. I have been with the Commission since July 1991.

16 Q. What are your major job responsibilities?

17 A. Since joining the Commission, I have worked with financial and affiliated interest issues
18 in the telecommunications and energy areas. In general, my current responsibilities
19 include advising the Commission on a range of financial issues such as rate of return and

1 capital structure, processing and analyzing securities issuance applications and approvals
2 of affiliated interest agreements, and participating in holding company audits.

3 Q. What is the purpose of your testimony in this proceeding?

4 A. The purpose of my testimony is to respond to testimony from Mr. Michael Rau given on
5 behalf of the city of Mequon and village of Brown Deer and Mr. Eric Rothstein given on
6 behalf of the intervening wholesale customers.

7 Q. Please comment on Mr. Rau's statement on page R2.57 of his May 14, 2010, rebuttal
8 testimony where he says, "Water main is a long life asset so the [Brown Deer Water]
9 Utility management decided to borrow capital for these projects so the current property
10 owner does not have to pay all the costs of an asset that will last for 100 years or more."

11 A. Mr. Rau's statement is related to property owners. In essence, it recognizes that nearly
12 all contributed capital (Capital Paid in by Municipality, Account 200) for a municipal
13 water utility comes from the city's property owners. Any earned surplus (Account 216.1)
14 of the water utility reflects earnings that could have been transferred to the city's general
15 funds and returned to the property owners through lower property taxes. Mr. Rau
16 assumes that all other city spending and borrowing are unaffected by water utility
17 funding, for example, that the city will not increase its borrowing to fund the utility or use
18 the utility distributions for funding projects which it might not have pursued without the
19 funding. Mr. Rau is concerned about intergenerational inequality, where a utility's
20 financing decisions force current property owners to fund all the costs of long-lived
21 assets.

22 In theory, the only way to eliminate all intergenerational inequality for property
23 owners would be to finance the utility with 100 percent debt. No contributed capital

1 would come from taxpayers and any current income would be transferred to the city and
2 returned to property owners. Such a capital structure is impractical. Furthermore, using
3 100 percent debt does not guarantee that the distributions will be returned to property
4 owners rather than used by the city for other purposes that the city might not have
5 pursued. However, the important point on this is that the issue is between the
6 municipality that owns the utility and its property taxpayers and encompasses municipal
7 finances and tax levies. Any Commission actions/directions/incentives on this issue
8 interweave with this relationship and, as I will discuss later, do not affect the revenue
9 requirement.

10 Q. Please comment on the Commission's methodology for establishing a rate of return and
11 Mr. Rothstein's concern on page R2.26 to R2.28 of his May 14, 2010, rebuttal testimony,
12 that Milwaukee Water Works (MWW) has too much equity in its capital structure.

13 A. As described by Commission staff witness Ms. Kathleen Butzlaff on page R12.2 of her
14 May 14, 2010, rebuttal testimony, the return on net investment rate base (NIRB) is based
15 on the cost of 30-year municipal debt plus 2 percent. This methodology is capital
16 structure neutral. Unlike the electric, natural gas, or combination utilities (which could
17 include water in addition to electric or natural gas), the Commission does not determine
18 separate costs for the capital components and then calculate a weighted cost of capital
19 based on capital structure. Under the Commission's methodology, a water utility with
20 100 percent equity would receive the same return on NIRB as a water utility with
21 50 percent equity. This means that the water utility customers do not incur additional
22 costs if the water utility has high equity levels. The only exceptions to this equal

1 treatment would be water utilities whose equity level is too low as to provide sufficient
2 cash flows or debt coverage.

3 The Commission does not have jurisdiction on the issuance of municipal utility
4 securities. However, under the Commission's methodology, all of the municipal utilities
5 shown in Mr. Rothstein's Exhibit 2.19 would receive the same return on NIRB and no
6 utility ratepayer would be disadvantaged by the capitalization chosen by the municipality.

7 In the 1990s, before telecom deregulation, the equity levels of Wisconsin's small
8 telecommunication utilities ranged from below 10 percent to 100 percent. In the case of
9 utilities with excessive capitalization, the Commission's focus was on ensuring that the
10 ratepayers did not pay for a higher rate of return than that of a typical utility. The
11 Commission's methodology for establishing a rate of return for water utilities already
12 accomplishes that goal.

13 Q. Please address Mr. Rothstein's comments on page R2.27 regarding whether MWW's
14 "predominant use of cash financing requires current ratepayers to cash finance long-lived
15 assets, resulting in intergenerational inequities. Ratepayers are asked to pay up front for
16 infrastructure that will convey benefits for 2 or more generations."

17 A. Unlike Mr. Rau's comments relating to property owners, Mr. Rothstein's statements
18 relate to ratepayers. Ratepayers and city of Milwaukee property owners are two separate
19 classifications and while a ratepayer may be a city of Milwaukee property owner, not all
20 ratepayers are.

21 Ratepayers pay for infrastructure through depreciation of and return on rate base.
22 The source of funding capital investments for MWW is revenue requirement neutral. The
23 utility may use its net income to finance capital investments or may distribute the net

1 income to its stockholders (in this case, the city of Milwaukee). Regardless of whether
2 the utility's capital investment is financed by retained equity or debt, the return on NIRB
3 included in rates would be identical under the Commission's methodology.

4 The depreciation rate could be a source of intergenerational inequality, providing
5 higher depreciation expense, higher customer rates and excessive cash flows too early in
6 the life cycle of the plant with the resultant opposite effect at the end of the life cycle. If
7 so, the problem should be addressed directly as a depreciation issue; changing the equity
8 level will not resolve the issue or save ratepayers any money.

9 Finally, Mr. Rothstein refers to Contributions in Aid of Construction (CIAC),
10 which he mentions on page R2.27. CIAC are payments by customers for specific
11 facilities relating to their service. The payments are made up front at the time the service
12 is established. Utilities seeking wholesale service may be required to make a
13 contribution. The source used by the purchasing utility to fund/finance the contribution is
14 determined by it when making the contribution. Any intergenerational inequity
15 associated with that funding is unrelated to the ratepayer or taxpayer of the municipality
16 furnishing the wholesale service (city of Milwaukee). Although the assets are booked on
17 the selling water utility's books (MWW), under the Commission's rate case methodology
18 these costs as well as the associated equity component are removed from rate base and
19 equity capital, so there are negligible, if any, revenue requirement impacts related to the
20 amount. Ratepayers of the utility purchasing wholesale service do not experience
21 inequity because of CIAC. The purchasing utility will bill its customers monthly (billing
22 period) for the amortization in the utility that provides wholesale service. However, the
23 taxpayers of the municipality that purchases wholesale service could be affected. The

1 wholesale purchasing utility makes its own choice about the source of funding or
2 financing for any CIAC that it provides to MWW. If the purchasing utility pays for its
3 CIAC to the utility supplying the wholesale service (MWW) through equity financing
4 there will be intergenerational inequity. If the purchasing utility pays for the CIAC
5 funded facilities by borrowing there is no inequity. The fact that the utility purchasing
6 wholesale service had to make a CIAC does not cause an inequity for its owners (the
7 taxpayers). If an intergenerational inequity results, it is only because of the method(s) the
8 utility purchasing wholesale service uses to pay the CIAC. In the case at hand, MWW is
9 not responsible for any intergenerational inequity to the utilities purchasing wholesale
10 service that result from CIAC funding. Furthermore, my discussion is not to imply
11 whether there are any CIAC payments made by any of the wholesale utilities to obtain
12 wholesale service from MWW, so this may not be applicable in this case. Any concerns
13 with the Commission's policy on CIAC affect all utilities, not just MWW, and should be
14 directed to a specific proceeding, not as adjustments to MWW's rates.

15 Q. Please comment on equity financing of capital investments.

16 A. The size of single year rate adjustments is related to the magnitude of the incremental rate
17 base, not the method of financing. From a rates perspective, it is irrelevant whether
18 MWW uses debt or equity to finance capital investments. From a capital investment
19 perspective, it is irrelevant provided the lack of debt financing is due to adequate equity
20 availability and is not an artificial restriction on investment to avoid debt issuance. I did
21 not make an assessment as to which case applies for MWW. Furthermore, if the
22 Commission were to order infrastructure investment, MWW has the discretion to finance
23 the investment with additional debt or capital contribution from the city of Milwaukee.

1 Q. Please comment on Mr. Rothstein's statement on page R2.32 that "Wholesale (and retail)
2 customers have paid for MWW to accumulate so much equity."

3 A. Ratepayers do not pay a premium because of MWW's equity level. In fact, under the
4 Commission's return methodology, customers in the utility would be more likely to pay
5 more if the utility's equity was too low. Absent proof that the Commission has been
6 including additional revenues not supported as expenses and return, it must be recognized
7 that all of MWW's earning equity is either contributed capital from the city of Milwaukee
8 or earnings it is entitled to earn on the city's contributed equity and earned surplus.
9 Furthermore, the cash flow associated with depreciation is simply the returning to the
10 investors of their investment in "consumed" plant. The use of that cash flow (both
11 earnings and depreciation related cash flow) for further investments is not the use of
12 ratepayer funds, but the reinvestment of the investors' contribution in additional rate
13 base. The high equity levels exist because MWW is retaining its earnings, not excessive
14 rates.

15 The alternative to using the cash flow for investment is to transfer the funds to the
16 city of Milwaukee's general fund and issue debt. This alternative does not reduce the
17 cost to ratepayers. The city of Milwaukee may use such a distribution to reduce taxes,
18 but doing so will only provide benefits for ratepayers who are also city of Milwaukee
19 property owners.

20 Q. Please comment on Mr. Rothstein's proposal, pages R2.34 to R2.36, to impute a lower
21 return based on a capital structure of 50 percent debt and 50 percent equity.

22 A. Mr. Rothstein calculates a return on NIRB of 3.50 percent which produces a total return
23 of \$10.3 million. Mr. Rothstein believes that this is more than what a utility with

1 50 percent equity would have received. If MWW did have a 50 percent capital structure,
2 Ms. Butzlaff would have determined that the return on municipal earning equity is
3 6.04 percent and the weighted return on NIRB would still be 5.18 percent. In absolute
4 terms, the operating income would be \$15.3 million. Reducing the weighted return on
5 NIRB would be a disincentive to the city. It would also provide a windfall to the non-
6 property owner customers, who under Commission current methodology are unaffected
7 by the capitalization of the water utility.

8 Q. Lastly, what was the capital structure and cost of debt and capital in MWW's last rate
9 proceeding docket 3720-WR-106?

10 A. The Commission's May 31, 2007, *Final Decision* in docket 3720-WR-106 states:

11 The applicant requested a return on net investment rate base of
12 3.30 percent. The applicant's capital employed in providing public utility
13 service is estimated to be 91.73 percent municipal equity and 8.27 percent
14 long-term debt. The composite cost of debt capital is 4.18 percent. *The*
15 *return requested by the applicant on rate base of 3.30 percent would*
16 *provide a return on municipal equity which is below the current cost of*
17 *municipal capital.* The applicant desires to mitigate the rate increase on
18 present water customers and believes that such return will generate
19 sufficient monies to meet its needs in the test year. (Emphasis added)

20 One reason that MWW was able to mitigate its rate increase in 2007, by accepting
21 a lower NIRB, was because its high equity levels still provided sufficient debt coverage.

22 Q. Please summarize your main points.

23 A. First, the issue of capital funding encompasses municipal finances and tax levies and any
24 Commission action/direction/incentive on this issue could affect the relationship between
25 the municipality and its property taxpayers.

26 Second, the Commission's methodology for determining a reasonable return on
27 NIRB is capital structure neutral. A change in the capital funding of MWW would not
28 impact the revenue requirement.

1 Third, accumulated earnings on rate base do not belong to the ratepayers but
2 belong to MWW and its owner, the city of Milwaukee and its property taxpayers.

3 Q. Does this conclude your supplemental direct testimony?

4 A. Yes, it does.

LJH:mem: